SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1940.

No. .

WILLIAM H. KNIFFIN, as trustee in bankruptcy of C. H. EARLE, INC., Bankrupt,

Petitioner,

—against—

STATE OF NEW YORK,

Respondent.

BRIEF IN SUPPORT OF PETITION.

I.

Opinions of the Courts Below.

No opinion was rendered in the Court of Claims of the State of New York. In the Appellate Division, Third Department of that State, Hill, *P. J.*, wrote for the unanimous Court, reported in 257 App. Div. 43, 12 N. Y. Supp. (2nd) 422 (p. 70).

For the Court of Appeals of that State, Sears, *J.*, wrote for the unanimous Court, reported in 283 N. Y. 317 (p. 76). No opinion was rendered on the denial of the petitioner's motion for reargument (p. 84), in that Court, reported in 284 N. Y. —— (page not yet officially assigned).

II.

Jurisdiction.

The grounds on which the jurisdiction of this Court is invoked, are set forth in the accompanying petition, to which reference is hereby made as though fully set forth herein. It is, therefore, not repeated.

III.

Statement of the Case.

The attention of the Court is respectfully directed to the petition herein which contains a general outline of the facts and is to be deemed repeated herein, although not reprinted, except as amplified in the argument.

IV.

Assignment of Errors.

The Court of Appeals of the State of New York erred:

(1) In failing to determine that the respondent had no right of off-set pursuant to Section 68 of the Bankruptcy Act (11 U. S. C. 108).

(2) In its construction that the Earle assignment to Raymond covered the Earle contract balance or any instalment other than the three instalments specifically recited in the instrument of assignment.

V.

Argument.

Point A.

After the bankruptcy of Earle and the intervention of the rights of its creditors, the State had no right to set-off against the contract balance due to Earle's trustee (the petitioner), the amount which the State paid for Raymond's judgment against the State, recovered as a result of the State's negligence.

Point B.

The assignment from Earle to Raymond covered only the three specified instalments so that the State could not justify paying Raymond out of the Earle contract balance after

those instalments had been paid and Earle's bankruptcy occurred.

POINT A.

After the bankruptcy of Earle and the intervention of the rights of its creditors, the State had no right to set-off against the contract balance due to Earle's trustee (the petitioner), the amount which the State paid for Raymond's judgment against the State, recovered as a result of the State's negligence.

The State Courts have failed to recognize the effect of Earle's bankruptcy and the rights of general creditors in the bankrupt's assets.

On July 22nd, 1929 when an involuntary petition in bankruptcy was filed against Earle (p. 48, fol. 142), the contractor had as its principal asset the large contract with the State of New York for the construction of part of Jones Beach Causeway. This job was not yet finished. After the bankruptcy, the State elected to complete the work through its own engineers. All general creditors of the bankruptcy-contractor had the right to depend upon the credit balance which would be found due to the bankrupt-contractor when the job was finished.

After the completion of the job, the State on April 9th, 1930 issued its certificate that $279,942.76 was available to the credit of the contract (p. 48, fol. 144).

The petitioner, Earle's trustee, had reason to believe that he would receive said sum, subject only to *applicable* liens and assignments. However, when the time came for the State to make payment, it insisted that there was only $247,426.63 available. The difference of $32,506.73 which had been deducted (wrongfully, according to the petitioner) was the amount of Raymond's judgment against the State, $30,703.68 and interest. The interest has been awarded to this petitioner by the Court of Appeals. Sears, *J.*, writing for that Court, in the next to the last paragraph of the opinion (at p. 80), said:

> "* * * As to the interest, however, there should be a modification. The State had in its hands, as found by the Court of Claims, funds sufficient to pay the Raymond account against the Earle Company before the Earle bankruptcy. It did not do so. As the delay in payment of the Raymond claim was due solely to the State's disregard of the terms of the assignment, no interest should be allowed thereon in favor of the State."

It seems strange, indeed, for that Court to have reached such conclusion with respect to the interest but not as to the principal, even though that, too, had not been paid to Raymond "due solely to the State's disregard of the terms of the assignment".

Throughout this proceeding the petitioner emphasized that although the respondent claimed, among other things, that it had made the deduction by virtue of the set-off permitted by Section 68 of the Bankruptcy Act, 11 U. S. C. § 108, the fact is that the source of the payment on June 9th, 1930 of Raymond's judgment was *not* the Earle contract balance but the purchase of an investment by the Comptroller for the Common School Fund (Claimant's Exhibit 16, at fol. 177). There is no dispute about that fact. It is contained in the Agreed Statement of Facts In Lieu of Testimony at page 49, folio 146.

Not until nine months thereafter, in March 1931, was the Common School Fund reimbursed for the payment of that judgment. The assignment of the Raymond judgment which the State's Common School Fund had taken on June 9th, 1930, was thus satisfied. Everyone agrees on that and it is so set forth in the opinion of Sears, *J.*, page 79. The reimbursement was made "from the appropriation made by the Legislature for judgments of the Court of Claims" (Claimant's Exhibit 16, p. 59, at fol. 177). The State's contrary assertion that in the intervening period it deducted the amount of the Raymond judgment and interest from the Earle balance, is a mathematical inconsistency, patently a belated after-thought. Earle's creditors were legally dam-

aged by this bookkeeping juggling because the contract credit balance was thus diminished.

It is respectfully urged that this Court should exercise its discretion by granting this application so that the error committed by the highest Court of said State can be corrected. Unfortunately, legal reasoning has been sadly obscured by that portion of the opinion of Sears, *J.* (p. 80), which states:

> "We find no significance in the facts relating to the manner of the payment of the Raymond judgment by the State. Whatever bookkeeping entries were made by the State, whatever practice was pursued to secure the money from State funds, the essence of the transaction is that the State paid the judgment when it paid Raymond, at least so far as the plaintiff is concerned. Even if we regard the transaction when the judgment was assigned by Raymond to the State for the Common School Fund as keeping the judgment unsatisfied and outstanding, it was afterwards paid and satisfied."

That is a model of inconsistency and contradiction. How can the State maintain at one and the same time that the Raymond judgment was unsatisfied by the assignment given to the Common School Fund (which held it for nine months) and yet previously satisfied by the deduction from the Earle contract balance?

In the Court of Claims proceeding instituted by Raymond against the State after the bankruptcy (Decision, p. 22, at fol. 65, findings #38, 39, 40 and 41), the State made no move to bring the bankrupt, its receivers or trustee into the suit (Agreed Statement of Facts In Lieu of Testimony, p. 48, fol. 144). This it could and should have done under former Section 20 of the Court of Claims Act (now Sec. 9, paragraph 5), which then read:

> "INTERPLEADER, CONSOLIDATION AND NEW PARTIES. Jurisdiction and powers are conferred upon the court of claims or a judge thereof to order other parties, known or unknown, to be brought in and made parties to any action or proceeding pending in such court,

> or substituted, whenever it appears or is made to appear to the court or a judge thereof necessary for a complete determination of a controversy or liability; * * * to consolidate claims or actions and to order interpleader, in the same manner and to like extent and with like effect in matters over which such court of claims have, or shall have, jurisdiction, as is conferred upon other courts by sections eighty-three, ninety-six, one hundred and ninety-three and two hundred and eighty-seven of the civil practice act, and section forty-eight of the surrogate's Court act."

Raymond pleaded a cause of action against the State only. Raymond did not seek to fasten its assignment or alleged lien against any contract balance due to Earle. Raymond took no part in the bankruptcy proceeding. It proceeded against the State in the Court of Claims which granted judgment against the State because of the latter's failure to comply with the terms of the filed assignment. (Decision of the Court of Claims in that case, Claimant's Exhibit 15, pp. 50, *et seq.*) The State had determined to litigate that issue by itself. It is bound by that judgment.

When the State made the criticized deduction, Earle's bankrupt estate was being administered by this petitioner. The State's right to a set-off had to be justified under Section 68 of the Bankruptcy Act, 11 U. S. C. 108. It was made almost a year after the bankruptcy without the approval of any Court, Federal or State. The claim at bar was filed to compel the State to submit to a Court its justification for the deduction.

At page 248 of Volume 4, Remington on Bankruptcy (4th Edition, 1935), states:

> "Sec. 1472. COURT ACTION TO MAKE OFF-SET AVAILABLE: The right of set-off can be exercised by the parties before the bankruptcy; but, after the bankruptcy, set-off is under the control of the court, and is not automatic but required action on the part of the parties interested to make it available.
>
> Sec. 68 (a) U. S. Code, title 11, Section 108 is not self-executing. It contemplates judicial action, for it

> provides that the account shall be stated, offset be made and the balance only allowed."

To the same effect is Collier on Bankruptcy, 13th Edition, Volume 2, page 1603.

The following is quoted from *Cumberland Glass Co.* v. *DeWitt*, 237 U. S. 447, 59 L. Ed. 1042, 35 Sup. Ct. 636, 34 A. B. R. 723:

At page 455:

> "The language of the act indicates the necessity of action by the court, for the statute provides that 'the account shall be stated', and the one debt set off against the other, and the balance only allowed to be paid. This statute recognizes the nature of set-off, as established in common law and equitable procedure. * * *"

At page 456:

> "If it (the State) had the right to do so, it did not seek the action of the bankruptcy court to state the account or make the settlement, and we have been unable to find any case, and none is called to our attention, in which it is held that simply because of the bankruptcy proceedings and the filing of the schedule and proofs of debts the set-off is automatically made between parties holding mutual credits. On the other hand, as the act indicates and so far as we know, all the authorities hold this section is not self-executing, but its benefit is to be had upon the action of the district court only when it is properly invoked, and that court has the primary duty of determining for itself whether there are 'mutual debts or credits' that should be set off one against the other according to the true intent and meaning of the Bankruptcy Act." *

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* (We do not contend that only the Federal Court has the right to pass upon a set-off. Apparently, that can also be determined in the State Court to which jurisdiction is granted by the conflicting parties. *Smith* v. *Hale*, 56 S. D. 12, 227 N. W. 373, 17 Am. B. R. (N. S.) 104. In *re Petrich*, 43 Fed. (2nd) 435. 16 Am. B. R. (N. S.) 547.)

In this case, the respondent had *the burden of proof* to sustain its action in exercising the set-off. Remington, in Vol. 4, page 244, Section 1466, says:

> "BURDEN OF PROOF OF PROPRIETY OF OFF-SET. The burden of proof is on the debtor seeking to use the off-set to show it was received before the bankruptcy and without knowledge of the impending bankruptcy."
>
> *In Re*: *Shults*, 135 Fed. 623, 14 Am. B. R. 378;
> *Lowden* v. *Northwestern National Bank & Trust Company*, 84 Fed. (2nd) 847, 31 Am. B. R. 655.

The State cannot sustain that burden because it has not come within the prerequisites of the cited section of the Bankruptcy Act. Sub-division "a" thereof requires that the debts or credits be *mutual* between the estate of a bankrupt and a creditor. That is not the situation here. The State did not set-off its own claim against the contract balance. What the State did was to arrogate unto itself the right to recoup a judgment paid to its own judgment-creditor, not the bankrupt nor the petitioner. The judgment was based on its own negligence in failing to comply with the filed assignment.

In construing the cited section, Mr. Justice Butler wrote for this Court, at page 248, in

> *McCollum* v. *Hamilton National Bank of Chattanooga, Tenn.*, 303 U. S. 245, 58 S. Ct. 568:
>
> "The words 'debts' and 'credits' as there used are correlative. What is a debt on one side is a credit on the other. *Libby* v. *Hopkins*, 104 U. S. 303, 309."

That is not the situation here.

Moreover, Collier's on Bankruptcy, Vol. 2, page 1610, and Remington on Bankruptcy, Vol. 4, page 220, both repeat that the mutual demands must have existed *before* the filing of the bankruptcy petition and that each debt must be owed to the other party.

That is not the situation at bar. The State never claimed any set-off nor did it do anything in that direction until after it paid the Raymond judgment long after the bankruptcy.

The State knew that the fund in its possession belonged to other assignees, lienors and the trustee acting for general creditors of the bankrupt. The third payment due to Raymond was no longer in existence. The State had paid the judgment for its own neglect. It could not make itself a priority creditor of the bankrupt by subsequently deducting from the bankrupt's estate, Raymond's judgment with interest. This was more than Raymond could have obtained from the estate. At the time of the bankruptcy, Raymond was only a general creditor like the others. This third instalment which had been paid to the bankrupt was not in existence, could not be identified, could not be traced and there was no other similar or even lesser amount in the bankrupt's bank account at its bankruptcy. It was consequently neither a priority creditor nor a *cestui que* of any trust.

> *National City Bank* v. *Hotchkiss*, 231 U. S. 50, 34 S. Ct. 20, 58 L. Ed. 115.

Even adopting the State's argument, the best that it could accomplish would have been to step into the shoes of Raymond. Raymond's status was that of an unsecured general creditor but the State gave itself a priority, thus getting a new pair of shoes. In the bankruptcy proceeding, Raymond would have received the same dividends as all other general creditors. The State "grabbed" 100% plus interest.*

If the State really had the right to use the contract fund for such payment, why did it (a) refuse to pay Raymond's claim, (b) defend the Court of Claims action, (c) pay Raymond's judgment with interest, by resorting to the Common School Fund, (d) take an assignment of the Raymond judgment, and (e) subsequently reimburse that fund out of the 1931 appropriation for judgments of the Court of Claims? It must be concluded that the judgment of Raymond against

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* (Should this Court grant certiorari and, after argument, modify the judgment below, the State will be able to file its claim in the Earle bankruptcy proceeding [§57(n) of the Bankruptcy Act, 11 U. S. C. §93(n)], receive the dividends heretofore paid to all other creditors and participate rateably with them in the proceeds of the judgment at bar.)

the State was not the "mutual" debt of the State against the bankrupt estate.

Sub-division "b" of Section 68 declares that the set-off shall not be allowed if it "was purchased by or transferred to" the creditor (the State) after the filing of the petition or in certain instances within the preferential four months' period prior to the filing of the petition. (The portion of the section is significantly written in the negative.) The State failed to show that it did not come within the prohibited periods.

The purpose of the section is to prevent one creditor from obtaining advantage over the others.

> *Cumberland Glass Co.* v. *DeWitt,* 237 U. S. 447, 35 S. Ct. 636, 59 L. Ed. 1042, 34 Am. B. R. 723;
> *Continental & Commercial T. & S. Bank* v. *Chicago T. & T. Co.,* 229 U. S. 435, 33 S. Ct. 829, 57 L. Ed. 1268, 30 Am. B. R. 624;
> *Merchants National Bank,* v. *Sexton,* 228 U. S. 634, 33 S. Ct. 725, 57 L. Ed. 998, 30 Am. B. R. 278.

In the last cited case, Chief Justice White wrote, at page 643:

> "By the effect of the bankruptcy the rights of the parties became fixed. * * * It was in the power of neither class to set aside or frustrate as against the other the rights fixed by the adjudication and which it was the duty of the trustee to conserve and administer."

More recently, this Court in another situation, in which Section 68 was not involved, ruled that a claim obtained after bankruptcy was not entitled to priority.

> *U. S.* v. *Marxen* (*In re Monterey Brewing Co.*), 307 U. S. 200, 59 Sup. Ct. 811, 83 L. Ed. 1222.

There, the trustee in bankruptcy pointed out that the original creditor, the bank, had not presented or proved a claim in the bankruptcy court but assigned its claim to the government *after* the bankruptcy.

Mr. Justice Reed, writing for the unanimous Court (Chief Justice Hughes and Mr. Justice Douglas taking no part), said, at page 205:

> "* * * The statement of the case and the question certified show that the claim in bankruptcy of the Government is based upon the note, duly assigned to it after bankruptcy."

At page 207, the opinion continued:

> "We are of the view that Section 3466 is inapplicable to general claims in bankruptcy transferred to the United States or to which it has become subrogated on payment, after the filing of the petition, for the reason that the rights of creditors are fixed by the Bankruptcy Act as of the filing of the petition in bankruptcy. This is true both as to the bankrupt and among themselves. (Citations.) The assets at that time are segregated for the benefit of the creditors. (Citations.)"

The reasoning there employed applies with equal force to the situation at bar. Here, the State's right to a set-off, if any, did not arise until after the State paid the Court of Claims' judgment obtained by Raymond. That was long *after* the filing of the bankruptcy petition. Hence, subdivision "b" of Section 68 makes illegal the attempted set-off.

In view of all of the foregoing, it is apparent that the State Courts did not appreciate the applicability of the cited section and cases to the situation at bar. It is respectfully submitted that the determination of this national question is a proper subject for review by this Court warranting the exercise of discretion in favor of the granting of this application.

POINT B.

The assignment from Earle to Raymond covered only the three specified instalments so that the State could not justify paying Raymond out of the Earle contract balance after those instalments had been paid and Earle's bankruptcy occurred.

It is believed that the preceding point is of sufficient importance in and of itself to warrant certiorari. However, for

the sake of completeness and especially in view of the interest which the case at bar has engendered, this point must be urged as a vital reason for the granting of the application.

At no time during the proceeding, did either of the parties maintain that the assignment to Raymond covered any more than the three specific payments due to Earle after the said assignment. In the respondent's brief to the Court of Appeals, the Attorney General (at p. 3) stated that

> "the assignment provided that the instalments should be paid out of the three succeeding payments due to the contractor from the State."

Indeed, this had been stipulated by both counsel in the Agreed Statement of Facts in Lieu of Testimony, page 45, folios 135, *et seq.*

The source of that stipulation was the formal Decision at bar (p. 17, fols. 51, *et seq.*) which had been prepared and submitted by the Attorney General. These were taken from Claimant's Exhibit 15, the formal Decision of the Court of Claims in the case of Raymond against the State, where the body of the assignment was recited *verbatim* in Finding of Fact #10, page 53, folios 158, *et seq.* Despite all this, the Court of Appeals stated that the assignment (p. 79)

> "provided for its payment out of three subsequent estimates, but did not confine its assignment to said estimates. In other words, the assignment covered subsequent installments which might fall due under Earle's contract with the State in case the full amount had not already been paid to Raymond, no matter what was the reason for this situation resulting."

This is amazing in the light of the fact that Sears, *J.*, in the opening of the opinion (p. 76) quotes *verbatim* from the body of the assignment. There is no ambiguity in the instrument. Its clarity was never questioned.

The claimed justification for this conclusion is stated by the Judge to be (p. 79) that

> "The record does not contain the full text of the assignment from the Earle Company to the Raymond Company, which furnishes the basis of the State's position."

The fact is (as was thereafter demonstrated to the Court and not disputed by the respondent) that there is nothing else in the assignment but one paragraph of prefatory recitals and two closing paragraphs consisting of the usual power of attorney and witness clause. The case should have been decided on what was before the Court.

It is apparent that the Court of Appeals believed that the earlier determination of the Appellate Division could not be sustained on any other basis of fact. Certainly the Appellate Division did not dispute that the assignment meant what both counsel said it meant: "the three succeeding payments". Nevertheless, the Court of Appeals, as an expedient found it necessary for the support of its decision, to say that its construction was different.

The answer must be that the Court of Appeals realized that in no other way could it sustain judgment for the respondent on that issue. Thus, only could it say, "In this aspect, the bankruptcy of Earle is unimportant" (p. 79). With that vital legal question out of the way, the opinion then cited the only case mentioned therein, *Riverside Contracting Co.* v. *City of New York*, 218 N. Y. 596 (Rec., p. 80). But that case is not adequate support for the position taken because it did not deal with assigned moneys which had been paid out *before* the bankruptcy, as at bar. Nor was there involved a suit litigated only by parties in the respective positions of Raymond and the State, a judgment for Raymond because of the State's failure to comply with the assignment and the subsequent maneuvers of the State whereby the judgment was assigned and then paid.

The entire opinion of Sears, *J.*, is in the subjunctive mode, *viz.*: "If then, the assignment was not confined to the particularly specified payments * * *" (p. 79); and, "If our construction of the assignment is correct * * *" (p. 80). This is so far from the fact that we are compelled to urge it as a basis for review to prevent any re-occurrence in future litigation. Such an attitude deserves the attention of this Court on the merits.

It is recognized that this Court does not usually grant certiorari to review evidence and to discuss specific facts. However, on previous occasions this Court has not hesitated to declare an exception to the rule and to grant review where warranted. There is ample precedent for such reversal of a State Court. In

Interstate Amusement Co. v. *Albert,* 239 U. S. 560, 36 S. Ct. 168, 60 L. Ed. 439,

Mr. Justice Pitney wrote, at page 566:

> "But this rule has its exceptions, as, for instance, where there is ground for the insistence that a Federal right has been denied as the result of a finding that is without support in the evidence. *Southern Pacific Co.* v. *Schuyler,* 227 U. S. 601, 611; *North Carolina R. R.* v. *Zachary,* 232 U. S. 248, 259; *Carlson* v. *Washington,* 234 U. S. 103, 106."

So, too, Mr. Justice Sanford, in

Fiske v. *State of Kansas,* 274 U. S. 380, 47 S. Ct. 29, 63 L. Ed. 129,

reiterated, at page 385,

> "And this Court will review the findings of facts by a State Court where a federal right has been denied as the result of a finding shown by the record to be without evidence to support it; * * *."

More recently, in

United Gas Public Service Co. v. *State of Texas,* 303 U. S. 123, 58 S. Ct. 438, 82 L. Ed. 702,

at page 143, Chief Justice Hughes declared:

> "We make that analysis, not to determine issues of fact arising on conflicting testimony or inferences, and thus to usurp the function of the State Court as a trier of the facts, but to perform our own proper function in deciding the question of law arising upon the findings which the evidence permits. *Kansas City Southern Ry. Co.* v. *Albers Commission Co.,* 223 U. S. 573, 591."

Here, the State Court denied a federal right (under the Bankruptcy Act) to the petitioner by "finding" facts in an unambiguous assignment without evidence to support such finding. Raymond never claimed the assignment was effective for any payment beyond the third payment; nor did the State. Only the Court of Appeals did. It remains for this Court to clarify the legal situation.

Conclusion.

It is respectfully submitted, therefore, that this case is one which requires the granting of a writ of certiorari to the end that the errors committed by the State Courts in the decision of a federal question may be corrected.

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